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PRESENTATION

Noah Poponak - *Goldman Sachs - Analyst*

Okay, we'll get started with our next Aerospace and Defense presentation, which is going to be from L-3 Communications, and we have with us the CFO, Mr. Ralph D'Ambrosio. Ralph? Thanks for being with us.

Ralph D'Ambrosio - *L-3 Communications Holdings - CFO*

Thanks for having me, Noah.

Noah Poponak - *Goldman Sachs - Analyst*

Ralph will go through a presentation here and then we'll jump into Q&A.

Ralph D'Ambrosio - *L-3 Communications Holdings - CFO*

Good afternoon, everyone. So, I have a quick introduction on L-3, or overview, and I'll go through a few other charts and then we'll have Q&A with Noah and anyone else in the audience.

So, what is L-3? I assume that you all know that we're an aerospace and defense contractor. We're not a platform OEM. Instead, we are a Prime contractor in about two-thirds of our business, and what we're Prime on -- work like ISR systems, aircraft modifications, sustainment and maintenance, simulation and training, as well as enterprise and mission IT to include cyber security operations.

And in the other third of our business, we're a supplier of a broad array of electronic and communication systems that are used on both military and commercial platforms. Some of the key attributes about L-3 is that we're a very broad, diverse, technology company with numerous contracts. We don't have any significant concentration in any handful of contracts, so to give you an idea of what that means, our top 10 contracts generate about 17% of our sales. Our top 40 contracts generate about 27% of sales, and thereafter the numbers drop off dramatically. So, we're not tied to any single or handful of contracts in terms of our revenue and earnings base.

I said we're predominantly a military contractor, but we do generate about 30% of our sales with international or foreign government and commercial end customers, and that part of our business has been growing very nicely the last several years. Together they've grown in the high single digit rate, and the international and commercial businesses' growth has helped to offset the decline that we've experienced in our US Military business, coincident with the cyclical downturn that began in 2011. And we expect that those international and commercial businesses will continue to grow, and when our defense businesses return to growth we'll have -- they'll supplement the growth in our core defense businesses.

We have an efficient capital structure, in that we believe that we use the appropriate amount of leverage efficiently to enhance returns to our shareholders. We are an investment-grade credit at the first tier, Baa3 and BBB minus, and our intention is to maintain that investment-grade rating, not to improve it or to lose it.

And finally, the company has historically and will continue to generate a very high amount of cash flow compared to our earnings. It's been about 135% conversion the last couple of years, and I'll show you a chart on that in a few minutes.

Two weeks ago, we reported our third quarter earnings, and as we typically do, we updated our calendar year financial guidance which is summarized on this next chart. This guidance includes completing the internal review of our aerospace systems, which had some adverse impacts to our financial performance for 2014. The impact from the internal review and what we found there including conducting the review, has impacted our EPS unfavorably by $1.05 and our margins by 120 basis points. And I say we are clearly very disappointed by the misconduct and the related accounting errors that occurred at the aerospace systems group or segment, and we have taken the appropriate remedial actions. That said, the Company continues to be healthy and we continue to generate a significant amount of free cash flow.

The next chart shows our segment financial guidance for 2014. I'll have a couple of comments on each of the segments. Electronic systems, which will generate just above $4.5 billion in sales, that's our largest segment in terms of sales. We also have our highest margins in that segment. About 50% of sales come from international and commercial end markets and electronic systems. And we expect that electronic systems along with communication systems will be the key driver of core margin expansion at L3 the next several years.

I'll skip over aerospace systems for a moment. Communication systems, that business in terms of sales had several headwinds. Calendar 2014 compared to last year, those headwinds included sequestration cuts, lower tactical ISR funding, as well as lower army budgets, but the good news is that prospectively we see significantly less sales pressure in that segment going forward.

Aerospace systems, just above $4 billion in sales. The internal review findings impacted the margins negatively by about 190 basis points, and that's why they're down to 7% in calendar 2014. And we expect those margins to improve slightly as we go forward, even after -- well, most of it comes from taking away the internal review charge and expenses, and I'll have something to say about that in a few minutes when I talk about the outlook for 2015.

And then lastly, NSS, which is our smallest segment, at about $1.2 billion in sales. That has been the business that's been under the most pressure in terms of the marketplace the last several years. But that said, NSS has done very well competitively the last couple of years, doing a good job at gaining market share and maintaining margins in the face of some very difficult conditions including better buying power, intense price competition, as well as tighter US Government budgets for all types of services. A large portion of our cyber security business is in the NSS segment, and we've been building that business organically by pursuing targeted new business, and that's something that we'll continue to do next year and beyond that.

Moving forward to the outlook for 2015, and we covered this two weeks ago as well, on the third quarter earnings conference call, we expect that our sales will decline about $300 million or a little more than 2% next year versus 2014. That includes the DOD and US government business declining about 5%, which is roughly $450 million of which $250 million of that decline in sales is coming from the Afghanistan OCO drawdown, and offsetting some of those declines in the US Government business is continued growth in our international and commercial business of about 5%, or $150 million in sales for next year.

In terms of our margins and sales, the aerospace systems is confronting a variety of challenges and pressures on the top line. The drawdown, I talked about a $250 million decline in sales next year. Well, $230 million of that is in aerospace systems, particularly in the ISR systems sector. That segment's also been contending with budget shortfalls and reductions, and some of our legacy US military business, and then of course we also have the army C12 contract, which we expect to end next July 31. And that's also causing a sales headwind, but not a profit headwind. It's a profit positive.

The other segments, electronic systems, communication systems and NSS collectively, their sales are stabilizing and they will be expanding core margins, and that's in line with the expectations that we've had for them since the beginning of this year.

Next year, we're also going to deal with higher pension expense. We've estimated it to be approximately $73 million more of pre-tax expense versus 2014, and that's going to lower margins by about 60 basis points and EPS by about $0.56. That's being caused by first and foremost, the decrease in interest rates which is causing about a $49 million increase of pension expense and the balance is coming from impacts from the Highway and Transportation Funding Act, as well as changes in actuarial assumptions, mostly mortality rates.

In terms of the tax rate for next year, it's going to be similar to 2014 in that we continue to not assume that we'll have a Federal R&E credit, and the R&E credit is important and valuable to L-3 because we are a technology company, we spend a lot of money and invest a lot each year in R&D and if the R&E credit is reenacted, it generates a benefit for L3 of about $16 million a year in net income and cash flow which would translate to about $0.19 of EPS for 2015, and if it were to get reenacted retroactively, we could have two years of benefit in 2015 just like we did in 2013.

We expect to continue to generate robust free cash flow next year, about $925 million. That conversion from net income is going to exceed 140%, and as usual we're using most of our free cash flow in a responsible, disciplined manner, and we're going to be returning a good portion of it to our shareholders like we have in each of the last several years. And our starting point for next year is $500 million of share buybacks, and I explained a couple of weeks ago that we'll have the ability to do a lot more than $500 million in terms of share repurchases for next year, just like we have been doing in each of the last three years.

The next chart just shows you numerically what our preliminary outlook is for 2015, and I already covered all those points.

The next chart, I summarized what we believe to be the growth areas and opportunities that we have the next several years, and I segregated it between the DoD and other US Government business on one hand, and then the international and commercial markets in the other column. And as you can see, the company has a broad extensive portfolio of technologies and competencies, and these are some of the areas that we see propelling our growth into the future, and I'll talk about some of them very quickly. Under the DoD column, the first four areas all pertain, in one form or another, to operating in an A2/AD environment. What we've listed there is our communication capabilities, LPI/LPD means Low Probability of Intercept, Low Probability of Detection. Those are the types of data communications that you need to have in an A2/AD environment. We're also doing a lot of exciting work on space-based sensors and EO payloads, some very interesting things with small, unmanned systems, and we're also increasing our investment in radar and electric warfare systems. And earlier, actually not this year, about a year ago, we acquired a small company called Mustang Technology Group which brings us a lot of those capabilities and adds to the ones that we had already. Additionally, we're continuing to make investments in our sensor systems, and I listed on this chart the Micro EOIR turrets. We're also doing communications systems that will be used on smaller unmanned systems, as well as weapons, and we're continuing to make investments in cyber security, and the last item on the list there is an important one for us which deals with the classified world within the US government, where there are several opportunities and there will be significant growth opportunities in the future. And we're going to be increasing our R&D expenditures dramatically to address those markets.

On the international and commercial end markets, we continue to see growth in our mainstay markets which have typically been airborne ISR systems, training and simulation, as well as security and detection systems. The recent additions have been civil aviation and training systems, which we acquired with an acquisition we made a couple of years ago, and we named that business Link UK. We're gaining a lot of market share in that area, and it's a very promising long-term growth area for L-3, tied to the general commercial aviation trends. We've also over the last couple of years, we have begun to introduce many of our products and solutions that we typically and historically sold mostly to US military-type customers, because the demands coming from the DoD at that time was consuming all of our capability or capacity, but we began to introduce new products overseas like night vision equipment, sensor systems and tactical satcom equipment, and those are examples of products where we have very strong discriminators at competitive prices. And therefore, we're making a lot of inroads overseas in terms of picking up market share, and we expect to continue to have opportunities, to continue to gain market share and grow those sales even without growth in underlying foreign military budgets.

So, to summarize, we do have a lot of technologies, and we are continuing to invest in those technologies, and we see many opportunities for future growth the next several years.

Next chart takes a closer look at our free cash flow. I commented earlier that we have historically had very high earnings or net income to cash flow conversion. For 2013, and for 2012 for that matter it's just about 140%. And very close to that again in 2014, and I said we expect it to be north of 140% in 2015. And why do we have such good cash flow and high conversion? Very simply, we have a lot of non-cash expenses, a lot of them stem from our prior acquisitions and the way that we've been able to structure our acquisitions in a tax-advantageous manner. And those benefits we'll continue to enjoy in the future. The business is also very low capital intensity. We spend less than 2% of our sales in CapEx each year, that's because most of our value add comes from engineering, assembly, tax and other labor type of activities. And like other companies, we also have stock-based compensation and we match our 401(k) in common stock, and those are obviously non-cash.

We recognize that those do create share creep, and they require us to buy back a certain amount of our stock each year, but we're very transparent about that and we tell you what it is, and you can analyze it as you see fit. But the bottom line is that we continue to generate very strong free cash flow, and we expect that to continue into the future.

And here's a look at what we've done with our free cash flow for the last three years, including the estimate for 2014, and as you can see that we've been returning close to 100%, or in the case of 2014 we expect to return more than 100% of our free cash flow to our shareholders, mostly in the form of share buybacks as well as a steadily-increasing dividend in terms of a per-share dividend, which we've increased at the rate of $0.05 per quarter in each of the last seven or eight years. And I don't see why that would change prospectively.

So, to summarize, the Company has innovative technologies that are affordable, and they give the solutions to our customers that are needed regardless of the end market, military and commercial. That's a key discriminator for L-3. It's what's going to enable us to continue to grow the business, prospectively. The DoD budget is stabilizing and it's set to return to growth either in a year or two, depending with what Congress does with sequestration for FY 2016. And I expect that just like Congress legislated a trimming of the sequestration cuts for each of FY 2013, 2014 and 2015, they'll do the same for FY 2016, 2017. In each of those first three years of sequestration the sequester cuts were cut back, were trimmed by about $13 billion per year. And I expect or hope that we have similar action taken by Congress for each of the future succeeding years, starting with FY 2016.

I talked about our international and commercial business growing, and that's going to continue to be the case, and we're going to continue to generate a robust cash flow. So, the company is healthy, agile, and we're focused. And if anything we're going to in all likelihood sharpen the focus of the Company in the very near future. That's something we talked a lot about two weeks ago in terms of the topic of portfolio reshaping. So, that's something that as Mike said, our Chairman and CEO, we're going to pay a lot of attention to that and focus on strengthening and sharpening the focus of the business.

So, that concludes my comments, and I would like to answer any questions that you have. And I know Noah has a lot of questions for me.

QUESTIONS AND ANSWERS

Noah Poponak - *Goldman Sachs - Analyst*

I do.

Ralph D'Ambrosio - *L-3 Communications Holdings - CFO*

Do you want to give the audience a try first, or do you want to --?

Noah Poponak - *Goldman Sachs - Analyst*

Let me just ask you one, I've got lined up on what you just said. So, because you're the first defense company here to talk about the possibility of changing sequestration without me prodding them into doing it.

So, the changes that you referred to that have occurred in the past occurred while the DoD budget growth rate was negative. So, in that environment it seems easier to make a change because the growth rate, because it's coming down, and you say, well gee, it shouldn't come down, let's add some money back. Once you get into 2016 and beyond, even with sequestration, the growth rate goes positive because sequestration took a framework of growth, forever, and just shifted it downward. So, that would mean that in order to add money back to sequestration, those that do it would need to agree to take a low single digit growth rate and make it higher. Is that -- despite that being the case, is it still something you think you can do?

Ralph D'Ambrosio - *L-3 Communications Holdings - CFO*

Well, I guess first of all, if you look at the DoD budget in total, base and OCO, we still expect it to decline in FY 2016. So, it doesn't start growing until FY 2017. Secondly, it seems like many constituencies in Washington believe that we should have something less than full sequestration, and you start by looking at the administration's FYDP submitted earlier this year, which projected -- or projects -- budgets that are on average above the sequestration levels by about $25 billion per year. There are many Congressmen and Congresswomen and Senators who are supportive of more defense spending, and the fact of the matter continues to be that the budget, the defense budget, while stabilizing, is still in a constrained situation. And there simply is not enough budget to pay for all the priorities that the different services, armed services, have.

So, my comments were based upon what the actions that Congress took in the first three years of sequestration, and I said that I hope they take similar action for FY 2016 and beyond. So.

Noah Poponak - *Goldman Sachs - Analyst*

What does your in-theatre revenue do, 2016 versus 2015?

Ralph D'Ambrosio - *L-3 Communications Holdings - CFO*

Sure. So, our -- and we talked about this two weeks ago -- our current estimate for our Afghan OCO-related revenues for sales in 2014 is about $700 million, and I said that we expect that to decline about $250 million next year to roughly $450 million. Most of that decline is coming in the aerospace systems segment, it's $230 million. The remaining $20 million is in NSS, and I've been saying for a while that we expect our OCO sales to bottom in the 2016 time frame at somewhere between $300 million and $400 million total. I continue to believe that that will be the case.

So, the OCO headwinds should end for us in 2016.

Noah Poponak - *Goldman Sachs - Analyst*

So, if that's a smaller headwind and a pretty small headwind as a percentage of the company in 2016, and if US DoD is flattish or maybe up, if they change sequestration, and international's still up, it seems like 2016 has a good chance. There's certainly scenarios where 2016 is up?

Ralph D'Ambrosio - *L-3 Communications Holdings - CFO*

There could be. And we'll have more to say about 2016 over the next few months or so. But right now we'd say that 2016 looks like the top line would be flat to maybe up 1%. That's because of the headwinds in the OCO that I just talked about. Plus, we're expecting that the Army C12 contract, I said it's going to end for us on July, next July that is, and that's going to be about $115 million sales headwind, but not a headwind to profits in 2016.

Noah Poponak - *Goldman Sachs - Analyst*

Anybody in the audience with a question? Over here?

Unidentified Audience Member

Early on in the presentation you called out your cap structure as most efficient with an alignment of ratings at BBB minus. But on the most recent earnings call, it was pointed out that your ability to reduce that is limited given your maturity profile, and it seemed like there was some hesitance to use any kind of proceeds from asset sales that might come, towards that reduction. And obviously, you're structure limited again in your maturity profile to do that. But your leverage has creeped up a couple ticks from year-end 2013, so how should we think about your adherence to the ratings where they are now? Are you willing to let those go down if there's deterioration in the business, or any more surprises that might hit the EBITDA profile?

Ralph D'Ambrosio - *L-3 Communications Holdings - CFO*

Well, one of the comments that I made was that we're committed to maintaining the investment grade rating. So, there are a lot of variables that go into that equation but we do pay attention to how the different rating agencies measure our leverage, and they each have different calculation methodologies. We do expect that soon we'll begin to grow our operating income, and that's going to be a favorable characteristic for all, anybody concerned, including creditors. So, aside from that I'm not sure what else I can tell you. But we are committed to maintaining the investment-grade rating.

Noah Poponak - *Goldman Sachs - Analyst*

Any other questions? Right here?

Unidentified Audience Member

There's recently been pretty solid growth in commercial aviation out of a lot of emerging markets, A-Pac, Middle East. Can you just talk about your exposure for the civil aviation training and simulation in those regions, and can you just give us an idea of the size of that total including developed markets?

Ralph D'Ambrosio - *L-3 Communications Holdings - CFO*

Okay. So, our -- in terms of aviation products, our commercial sales are about $250 million in total. And we do have exposure to the Asia-Pacific markets including China, and that exposure is increasing. We've made some investments the last couple years, and I expect that we're going to continue to grow in those areas. And frankly, that's a key area of growth in the future, so you need to be there, particularly China.

And our civil aviation training simulation business is about $150 million per year and growing, and we expect that's going to continue to grow. And a substantial portion of that is in the Asia-Pacific market already. So, as I said earlier, we expect to have good long-term growth fundamentals in our commercial businesses including in those two aviation-related markets, products and simulation.

Noah Poponak - *Goldman Sachs - Analyst*

Any other questions? One on cash flow. In the chart where you break down the components of free cash flow, the working capital, change in working capital number is a negative, in all the years you've shown. What can you do to change that?

Ralph D'Ambrosio - *L-3 Communications Holdings - CFO*

Okay. So, it is a negative. I would characterize it as a minor negative, and the reason for it is well, I talked about our ability to increase our international and commercial sales, which we have been doing. And those markets have slightly higher working capital requirements. They just don't finance as well as US government business does. And additionally, even in some of our US military and our foreign military work, we've been liquidating some customer advances, which have also factored into those modest reductions or increases in working capital.

Noah Poponak - *Goldman Sachs - Analyst*

I mean, it's a -- the business isn't growing, so I get investments in certain pieces of the business, but on a total basis if -- usually if a business isn't growing the top line, it can get the working capital improvement. I mean, is there a potential for that to shift into positive territory beyond 2014?

Ralph D'Ambrosio - *L-3 Communications Holdings - CFO*

Certainly, and I don't expect it to become more of a use of cash flow. Also, I talked about better buying power, or the Department of Defense efficiency initiatives, which began about four years ago. They also had the impact of making contract financing terms less attractive than they used to be, so that's also part of that working capital usage.

Noah Poponak - *Goldman Sachs - Analyst*

And then just -- we're just about out of time, but can you just talk about margins for a little bit, and it seems like the overall framework we should have in mind for the next few years is, there's a decent amount of margin upside potential at [ES] and that seems largely mix-driven, and then the others should just have kind of modest improvement over time. Is that fair?

Ralph D'Ambrosio - *L-3 Communications Holdings - CFO*

Yes, and to add some specifics to those points, so I've said that we expect to have our best margin expansion opportunities in electronic systems, and communication systems. In 2011, our margins in electronic systems were just above 13%, and just about 11% in communication systems. I don't see why we can't return to those margin [core] levels over the next couple, two to three years, and that's something that we're managing the business to get there.

Aerospace systems, we talked about this two weeks ago, took a step backwards particularly in the logistics solutions sector. So, that's certainly taking away some of our consolidated margin expansion profile, but we still have significant opportunities coming out of ES and CS. And I expect that we'll eat least hold our own in NSS, possibly expand those margins, modestly over the next few years.

Noah Poponak - *Goldman Sachs - Analyst*

Okay, with that, we are out of time. Thank you very much for being with us.

Ralph D'Ambrosio - *L-3 Communications Holdings - CFO*

You're welcome, thanks for having me.

Noah Poponak - *Goldman Sachs - Analyst*

Appreciate it.
